

General Information Letter: Subtraction modification for reasonable compensation for personal services rendered by a partner.

April 3, 1998

Dear:

This is in response to your letter dated April 3, 1998, in which you request a letter ruling. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax laws and are not binding on the Department. For your general information we have enclosed a copy of 2 Ill. Adm. Code Part 1200 regarding rulings and other information issued by the Department.

Although you have not specifically requested either type of ruling, the nature of your question and the information provided require that we respond only with a GIL.

In your letter you have stated the following:

We spoke via telephone on Friday March 27, 1993.

I was getting conflicting information from two employees of the IL Dep Rev. I identified each verbally to each other by location but not by names, but I have no idea if they ever spoke to each other.

Rather than going through a lot of re-explaining, I have enclosed a copy of a letter I wrote early in February of this year to an IDR box #.

About a month later, after not securing a response, I called the IDR in Spgfld to get a response to the letter. I was connect to a woman (whose name I do not remember) to whom I explained the situation. She said we were liable for the replacement tax, no ifs, ands or buts -- MY words, She said the Marion IDR person was wrong. I accepted her answer.

About 1 - 2 weeks later, the same woman called me from IDR - Spgfld responding to my letter. We agreed that we had had the above conversation earlier. I mentally accepted her response again.

March 27 I started to complete the 1997 IL 1065 form to get it out of the way. I read the IL 1065 instructions again, so I decided to call the Marion IDRT to let him know he was wrong. In my conversation with him, he would not agree that he was incorrect. He suggested I call one or both of two IDR numbers - Legal 217-782-6996 and another with a

name of someone who he respected perhaps with more information on the subject.

I elected to call legal and you answered.

I read the attached letter to you and you said (in essence) that each of the IDR people I had spoken with were correct.

You explained by way of an analogy with corporate taxes. Corporations are taxed on their profit BEFORE dividends are paid to shareholders. However, corps. have employees who are paid which salaries thus become expenses which in effect offset part of the profit.

In the case of our wife / husband partnership, our profit does NOT reflect any salary or reimbursement for our own time in this profit making effort.

As another example you said you were in the process of explaining the same principle to a partnership which involved \$millions.

This made sense to me - and also made me feel more comfortable with the application of the law.

You suggested that I determine what the time expended was for each of my wife and myself in our business venture over the taxable year, apply a fair rate of value / hour for our labor, and use that figure for line 5c of part I of IL 1065.

WE (you and I) also concluded that if we (my wife & myself) calculated this out, it might show that we are really operating at a loss.

I also pointed out that we have been paying this tax since 1990 (see matrix with the letter). You said we could go back only three years, in an effort to get refunds. So I need to get calendar year 1994 in for an amended return prior to 04/15/98.

FYI, The first thing I did after conversing with you was to identify on paper what we each do in this business. I made a form to use for past and future years to calculate (in a time / motion study manner) a reasonable figure for IL 1065 Part I, line 5c. I will keep such a form in our Fed/IL 1065 file for applicable tax years.

I took me a long time to tell this tale, but I wanted to touch all the bases for posterity and the possibility of an IDR audit.

I asked for written confirmation from you of our conversation. You said for me to write you and you would respond.

## Ruling

Section 201 of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 et seq.) imposes two separate taxes: the so-called "regular" income tax and the Personal Property Tax Replacement Income Tax, or "Replacement Tax."<sup>1</sup> The regular income tax is imposed on individuals, trusts and estates at the rate of 3% of net income and on corporations at the rate of 4.8%. Section 201(b) of the IITA.

Partnerships and Subchapter S corporations are exempt from the regular tax. Section 205(b) and (c) of the IITA. Instead, the partners and shareholders of these entities are taxed on their shares of the entities' income in the same manner as for federal income tax purposes.

The Replacement Tax is imposed on corporations at the rate of 2.5% of net income and on trusts, partnerships and Subchapter S corporations at the rate of 1.5%. Section 201(d) of the IITA.

Accordingly, the income of all business entities is subject to two income taxes under the IITA. Corporations pay both taxes. Partnerships and Subchapter S corporations pay the Replacement Tax on their incomes, while the owners of these entities pay the replacement tax on their shares of the entities' incomes.

As we discussed on the telephone, a Subchapter S corporation is allowed for federal income tax purposes to deduct salaries paid to its shareholders for personal services rendered as employees of the Subchapter S corporation, and this deduction carries over into the computation of Illinois net income. Section 203(b)(1) of the IITA. On the other hand, partnerships do not as a rule pay salaries to their partners for personal services rendered, and thus there is no deduction allowed for federal income tax purposes. However, in computing the net income of a partnership subject to Replacement Tax, Section 203(d)(2)(H) of the IITA allows a deduction for:

Any income of the partnership which constitutes personal service income as defined in Section 1348(b)(1) of the Internal Revenue Code (as in effect December 31, 1981) or a reasonable allowance for compensation paid or accrued for services rendered by partners to the partnership, whichever is greater . . .

This deduction is taken on line 5c of Part I of the Form IL-1065.

As we discussed on the telephone, the IITA does not prescribe any particular method of determining a "reasonable allowance" for compensation for services you and your wife render to your partnership. One reasonable method of doing so would be to do as you described: to determine the number of hours each of you worked in performing personal services for the partnership during a particular year, and multiplying that amount by a fair hourly wage.

The correct number of hours each of you worked for the partnership during a year and the proper level of wages for your services are factual matters, and we cannot give you a legal opinion as to whether the amounts you use in computing your allowance for compensation are correct. Such a determination can only be made upon an audit or hearing in which all of the facts are presented and considered.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you wish to obtain a PLR which will bind the Department with

respect to the application of the law to specific facts, please submit a request conforming to the requirements of 2 Ill. Adm. Code Part 1200. Please note, however, that a PLR cannot apply the law to a hypothetical situation and a PLR is not binding with respect to a statement of facts which is incomplete or incorrect. Accordingly, the Department does not ordinarily issue PLRs in response to requests based on unsupported conclusions of fact or which are, in effect, requests for determinations of fact. Given the inherently factual nature of the issues in your inquiry, we believe it is unlikely that we will be able to issue a PLR in this instance.

Sincerely,

Paul S. Caselton  
Associate Chief Counsel -- Income Tax

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1     The Personal Property Tax Replacement Income Tax was enacted pursuant to the provision in Article IX, Section 5(c) of the Illinois Constitution of 1970, which required the General Assembly to abolish all personal property taxes by January 1, 1979 and to "replace the revenue lost by units of local government and school districts as a result" by enacting new taxes, hence the awkward name.